SUMMARY OF TAX PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL

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of the

JOINT COMMITTEE ON TAXATION



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INTRODUCTION

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides a summary of the tax provisions contained in the President's Fiscal Year 2001 Budget Proposal. The pamphlet generally follows the order of the proposals as included in the Department of the Treasury's explanation.²

¹ This pamphlet may be cited as follows: Joint Committee on Taxation, *Summary of Tax Provisions Contained in the President's Fiscal Year 2001 Budget Proposal* (JCX-13-00), February 7, 2000.

² See Department of the Treasury, <u>General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals</u>, February 2000.

SUMMARY OF TAX PROVISIONS IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET

A. Expand Education Initiatives³

College opportunity tax cut

The proposal would expand the current Lifetime Learning credit by increasing the credit rate of 20 percent of qualified tuition and related expenses to 28 percent. The credit would be phased out ratably for taxpayers with modified adjusted gross income ("AGI") between \$50,000 and \$60,000 (\$100,000 and \$120,000 for joint returns). In lieu of the credit, the proposal would permit taxpayers to elect to claim a deduction for qualified tuition and related expenses of up to \$10,000 (\$5,000 in 2001 and 2002). The deduction would be subject to the same AGI phase-out ranges as the credit.

Extension of authority to issue qualified zone academy bonds and expansion to include authority to issue qualified school modernization bonds

The proposal would expand and extend authority to issue qualified zone academy bonds ("QZABs") (currently in effect through December 31, 2001) by an additional \$1 billion in 2001 and \$1.4 billion in 2002. QZABs are bonds issued by States or local governments to finance construction and equipment for "qualified zone academies" which are elementary and secondary schools receiving financial assistance from both governments and private businesses. Other technical modifications would be made to the QZAB program. The budget proposal also would create a new category of tax-credit bonds for qualified school modernization programs. Authorized annual issuance would be \$11 billion nationwide in calendar years 2001 through 2002.

Expand exclusion for employer-provided educational assistance to include graduate education

The present-law exclusion for amounts paid or incurred by an employer for certain educational assistance applies to undergraduate courses beginning before January 1, 2002. The proposal would reinstate the exclusion for graduate education (which expired in 1996), effective for courses beginning after July 1, 1999, and before January 1, 2002.

³ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the College Opportunity Tax Cut.

Eliminate 60-month limit on student loan interest deduction

The proposal would eliminate the limit on the number of months during which interest paid on a qualified education loan is deductible.

Eliminate tax on forgiveness of direct student loans subject to income contingent repayment

The proposal would allow a taxpayer to exclude from income any amount the taxpayer would otherwise include as a result of the forgiveness of a student loan made under the Direct Loan program where loan repayment and forgiveness are contingent on the borrower's income level.

Tax treatment of education awards

The proposal would provide that amounts received by an individual under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program are "qualified scholarships" excludable from income, without regard to any service obligation by the recipient. In addition, the proposal would provide that any repayment or cancellation of a student loan under the NHSC Scholarship Program, the Americorps Education Award Program, or the Armed Forces Health Professions Loan Repayment Program is excludable from income.

B. Provide Poverty Relief and Revitalize Communities⁴

Expand and simplify the EIC

The proposal would make five changes to the EIC. First, it would provide a larger EIC to families with three or more qualifying children. Second, it would increase the beginning point of the phase-out range of the EIC for married couples filing joint returns by \$1,450. Third, it would reduce the phase-out rate of the EIC for families with two or more children from 21.06 percent to 19.06 percent. Fourth, it would provide that nontaxable earned income not be treated as earned income for purposes of the EIC. Finally, it would modify the EIC treatment of taxpayers who lack taxpayer identification numbers for otherwise qualifying children.

⁴ Similar or identical proposals were included in the President's Fiscal Year Budget Proposal, except for the proposals to: (1) expand and simplify the EIC; (2) extend and expand empowerment zones; and (3) to provide an enhanced deduction for corporate donations of computers.

Increase and index the low-income housing tax credit per capita cap

Under the proposal, the annual State low-income housing credit allocations to each State would be increased to \$1.75 per capita for calendar year 2001 and indexed for inflation.

Provide new markets tax credit

The proposal would create a new tax credit for qualified investments made to acquire equity interests in selected entities certified by the Treasury Department as eligible community development entities ("CDE"). To qualify as a CDE, an entity must use substantially all of the investment proceeds to make equity investments in, or loans to, qualified active businesses located in low-income communities.

The credit allowed to the investor would be a six-percent credit for each year during the five-year period after the equity interest is purchased from the CDE. During the period 2001-2005, the maximum amount of investments that would qualify for the credit would be capped at an aggregate annual amount of \$3 billion (a maximum of \$15 billion for the entire period of the tax credit).

Extend and expand empowerment zone incentives

The proposal would provide for the designation of ten new empowerment zones (of which eight would be located in urban areas and two would be located in rural areas). During the period 2002 through 2009, businesses located in the new empowerment zones would qualify for (1) the wage credit, (2) an additional \$35,000 of section 179 expensing for "qualified zone property" placed in service by an enterprise zone business; and (3) special tax-exempt financing for certain zone facilities.

The proposal also would extend the designations of the existing empowerment zones through December 31, 2009, and would extend and expand the current tax incentives (i.e., the wage credit and additional section 179 expensing) to businesses in existing empowerment zones.

Tax credit for sponsorship of qualified zone academies and technology centers

The proposal would permit businesses to claim a tax credit equal to 50 percent of cash contributions made to a qualified zone academy, or public library or community technology center located in a designated empowerment zone or enterprise community.

Enhanced deduction for corporate donations of computers

The proposal would extend the enhanced deduction for donations of computer technology and equipment through June 30, 2004. In addition, the proposal would expand the deduction to apply to contributions of computer equipment to a public library or community

technology center located in a designated empowerment zone or enterprise community or in a census tract with a poverty rate of 20 percent or more.

Tax credit for employer-provided education programs in workplace literacy and basic computer skills

The proposal would permit employers to claim a tax credit for expenses of providing certain workplace literacy, English literacy, basic education, and basic computer training programs for their eligible employees. The amount of the credit would equal 20 percent of the employer's eligible expenses incurred with respect to qualified education programs, with a maximum credit of \$1,050 in a taxable year per participating employee.

Provide tax credits for holders of Better America Bonds

The proposal would provide a tax credit to holders of Better America Bonds issued by State or local governments for: (1) acquisition of land for open space, wetland, public parks or green ways to be owned by the State or local government or section 501(c)(3) entity whose exempt purpose includes environmental preservation; (2) construction of visitors facilities to be owned by the State or local government or section 501(c)(3) entity whose exempt purpose includes environmental preservation; (3) remediation of land acquired under (1) above, or of publicly owned open space, wetlands, or parks, undertaking reasonable measures to control erosion or protect endangered species, and remediating conditions caused by prior disposal of toxic or other waste; (4) acquisition of easements on privately owned open land that prevent commercial development and any substantial change in the use or character of the land; (5) environmental assessment and remediation of brownsfields contaminated property owned by State or local governments if the property was acquired: (a) by the State or local government before January 1, 2000; or (b) by reason of foreclosure or abandonment by the prior owner; or (6) environmental assessment and remediation of certain property damaged by anthracite coal mining if the property is owned by a State or local government, or section 501(c)(3) entity.

Make permanent the expensing of brownfields remediation costs

The proposal would make permanent the deduction under section 198 for brownfields remediation costs.

Specialized small business investment company tax incentives

The proposal would increase the benefits of the tax-free rollover provisions for taxpayers investing in interests in specialized small business investment companies and would increase the capital gain exclusion in certain investments in those companies from 50 percent to 60 percent.

C. Make Health Care More Affordable⁵

Assisting taxpayers with long-term care needs

The proposal would provide a \$3,000 tax credit for taxpayers with long-term care needs and for taxpayers with a spouse or qualifying dependent with long-term care needs. The credit (aggregated with the child credit and the proposed disabled worker credit) would be (1) refundable for a taxpayer claiming three or more credit amounts, and (2) phased out over certain levels of adjusted gross income.

Encourage COBRA continuation coverage

Present law requires an employer to offer covered individuals the opportunity to continue coverage under the employer's health plan for a temporary period after termination of employment or the occurrence of certain other events that would result in a loss of coverage. Employers may charge individuals up to 102 percent of the average cost of group health insurance for such continuation coverage. Under the proposal, individuals electing continuation coverage would be entitled to a tax credit equal to 25 percent of the individual's premium for the coverage.

The proposal would expand the availability of COBRA continuation health coverage by permitting retirees age 55 to 65 whose former employer eliminates retiree health coverage after retirement to elect to continue coverage under their former employer's health plan (until attainment of age 65). The employer could charge such individuals a premium of up to 125 percent of the employer's group health insurance premium. The 25 percent credit for COBRA premiums would apply to the purchase of such insurance.

Provide tax credit for Medicare buy-in program

Nonrevenue provisions of the President's Fiscal Year 2001 Budget Proposal would permit certain individuals age 62 to 65 and displaced workers ages 55 to 65 to purchase coverage under Medicare. Individuals purchasing such coverage would be entitled to a tax credit equal to 25 percent of the premium for such coverage.

Provide tax relief for workers with disabilities

The proposal would provide a tax credit to disabled individuals, not to exceed the lesser of \$1,000 or the individual's earned income for the taxable year. The credit (aggregated with the child credit and the proposed long-term care credit) would be: (1) refundable for a taxpayer

⁵ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposals to: (1) encourage COBRA coverage (2) provide a credit for the Medicare buy-in program; and (3) encourage the development of vaccines for targeted diseases.

claiming three or more credit amounts; and (2) phased-out for high-income taxpayers.

Provide tax relief to encourage small business health plans

Under the proposal, any grant or loan made by a private foundation to a qualified health benefit purchasing coalition to support the coalition's initial operating expenses would be treated as a grant or loan made for charitable purposes. In addition, the proposal would provide a tax credit for small businesses who have not had a health plan and who purchase health insurance through a qualified health benefit purchasing coalition. The credit would be equal to 20 percent of employer contributions to employee health plans. The maximum credit per policy would be \$400 per year for individual coverage and \$1,000 per year for family coverage. Both of these proposals would be temporary.

Encourage the development of vaccines for targeted diseases

The proposal would create a credit equal to 100 percent of the revenue received from the sale of a vaccine against certain targeted diseases to a qualified nonprofit organization. Total credit claimed would be subject to an annual limitation allocated by the U.S. Agency for International Development ("USAID"). The targeted diseases would include malaria, tuberculosis, HIV/AIDS, and others subsequently designated by the Secretary of the Treasury.

D. Strengthen Families and Improve Work Incentives⁶

Provide marriage penalty relief and increase the basic standard deduction

The proposal would make two changes to the present-law basic standard deduction. First, the amount of the standard deduction for two-earner married couples filing a joint return would be increased to an amount equal to the lesser of: (1) the sum of the amount of the standard deduction for one-earner married couple filing a joint return plus the smaller of the two spouses' earned income; or (2) the amount of the new standard deduction for two-earner couples filing a joint return. Second, it would increase the basic standard deduction by \$250 for single filers, \$350 for heads of households, and \$500 for married couples filing a joint return.

Increase, expand and simplify the child and dependent care credit

The proposal would make several changes to the basic credit and create an additional nonrefundable credit of \$250 for a child under the age of one (\$500 for two or more children). The changes to the basic credit would: increase the maximum amount of the credit to \$1,200 for one child (\$2,400 for two or more children); increase the income level at which the credit rate

⁶ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposal to provide marriage penalty relief and increase the standard deduction.

begins to be phased-down to 20 percent from \$10,000 to \$30,000 of adjusted gross income (AGI); make the basic credit refundable; and repeal the present-law household maintenance test (except in the case of married couples filing separately). Both the basic credit and the additional credit for children under the age of one would be indexed for inflation.

Provide tax incentives for employer-provided child care facilities

The proposal would allow an employer tax credits not to exceed \$150,000 annually, equal to 25 percent of certain qualified expenses of employee child care (e.g., the cost of acquiring and operating a qualified child care facility) and 10 percent of child care resource and referral services.

E. Promote Savings, Retirement Security, and Portability⁷

Retirement Savings Accounts

The proposal would provide a tax credit to employers and financial institutions that match contributions made by eligible taxpayers to a section 410(k) plan or an IRA. The credit would be available for basic matching contributions of up to 100 percent of the first \$1,000 of contributions and for additional matching contributions of up to \$100 for the first \$100 contributed to the account. The amount of basic and matching contributions would be phased out for taxpayers with AGIs above certain limits.

Small business tax credit for qualified retirement plan contributions

The proposal would provide for small businesses a 3-year tax credit for 50 percent of certain employer nonelective or matching contributions to qualified retirement plans on behalf of nonhighly compensated employees. Qualifying contributions would equal not less than 1 percent and not more than 3 percent of compensation. The credit would be available for 50 percent of

⁷ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for: (1) Retirement Savings Accounts; (2) small business tax credit for qualified retirement plan contributions; (3) enhancements to SIMPLE 401(k) plan nonelective contribution alternative; (4) eliminate IRS user fees for initial determination letters for small businesses adopting a qualified retirement plan for the first time; (5) simplify prohibited transaction provisions for loans to individuals who are S corporation owners or self-employed; (6) increase defined contribution plan percentage of pay limitation; (7) certain elective contributions not taken into account for purposes of deduction limits; (8) conform definition of compensation for purposes of deduction limits; (9) tax treatment of the division of section 457 plan benefits upon divorce; (10) encourage pension asset preservation by default rollover to IRAs of involuntary distributions; (11) Thrift Savings Plan portability proposals; permit accelerated funding of defined benefit plans; and (12) increase disclosure for pension amendments that reduce the future rate of benefit accrual.

defined benefit plan accruals that are equivalent to a 3-percent nonelective contribution to a defined contribution plan. Qualifying contributions and accruals would be subject to restrictions on vesting, distribution, and method of allocation or accrual.

Small business tax credit for expenses of starting new retirement plans

The proposal would provide a 3-year tax credit for 50 percent of the administrative and retirement education expenses for small businesses that adopt a new retirement plan. The credit would apply to 50 percent of the first \$2,000 in qualified expenses for the first year of the plan, and 50 percent of the first \$1,000 of expenses for each of the second and third years. The credit would be available only for plans established after 1998 and before January 1, 2010.

Promote Individual Retirement Account contributions through payroll deduction

Contributions of up to \$2,000 made to an IRA through payroll deduction would be excludable from gross income (but includible for FICA and FUTA tax purposes).

The "SMART" plan-a simplified pension plan for small business

The proposal would allow small employers to adopt a new, simplified tax-favored pension plan that combines features of defined benefit and defined contribution plans. SMART plans would provide participants with a minimum guaranteed benefit at retirement that provides payments over the course of an employee's retirement years, PBGC insurance, the potential for additional investment return, and portability. SMART plans would not be subject to nondiscrimination and top-heavy rules.

Enhancements to SIMPLE 401(k) plan nonelective contribution alternative

The proposal would permit an employer to make a nonelective contribution equal to up to 15 percent of compensation for all eligible employees. The employer would be permitted to wait until as late as December 1 of the year for which a contribution is made to determine the level of nonelective contributions for the year. The elective contribution limit for nonhighly compensated employees would be conformed to the limit that generally applies to 401(k) plans even when employers make no contributions. The elective contribution limit for highly compensated employees under the SIMPLE 401(k) nonelective contribution alternative would depend on the level of nonelective contributions made on behalf of all eligible employees.

Eliminate IRS user fees for initial determination letters for small businesses adopting a qualified retirement plan for the first time

The proposal would eliminate the IRS user fee for the initial determination letter of one qualified retirement plan maintained by a small business if (1) the employer did not maintain a qualified plan in 1998, (2) the employer had no more than 100 employees who received at least

\$5,000 of earnings in the preceding year, and (3) the qualified retirement plan covers at least one non-highly compensated individual.

Simplify prohibited transaction provisions for loans to individuals who are S corporation owners or self-employed

The prohibited transaction rules would be modified to permit loans from a qualified retirement plan to participants who are S corporation owners or self-employed persons whose ownership interest is less than 20 percent and by permitting loans that were exempted from the prohibited transaction rules when the company was taxable as a C corporation to continue to be exempted for 24 months after the first day of the first plan year beginning with or within the first tax year the company elects to be an S corporation.

Provide faster vesting for employer contributions to qualified retirement plans

Employer contributions under defined contribution and defined benefit plans would be required to be fully vested after an employee has 3 years of service, or to become vested in increments of 20 percent for each year beginning after the employee has two years of service, with full vesting after the employee has completed 5 years of service.

Count FMLA time toward retirement vesting and participation requirements

Leave taken under the Family and Medical Leave Act would be required to be taken into account in determining retirement plan eligibility and vesting.

Increase defined contribution plan percentage of pay limitation

The proposal would increase the maximum allowable annual addition, based on a percentage of pay, for defined contribution plans from 25 percent to 35 percent of compensation.

Certain elective contributions not taken into account for purposes of deduction limits

The proposal would increase the 15-percent deduction limit applicable to profit-sharing and stock bonus plans by the amount of contributions on behalf of nonhighly compensated employees participating in the profit-sharing or stock bonus plan that exceed, in the aggregate, 15 percent of compensation otherwise paid or accrued on behalf of those nonhighly compensated employees. Elective contributions that are deductible only as a result of this special rule would be disregarded for purposes of determining the amount deductible under the 25-percent limit applicable when an employee participates in both a defined contribution plan and a defined benefit plan.

Conform definition of compensation for purposes of deduction limits

Under the proposal, salary reduction amounts that are treated as compensation for purposes of section 415 would be treated as compensation for purposes of applying the limitations of section 404.

Improve benefits of nonhighly compensated employees under 401(k) safe harbor plans

The proposal would modify the matching contribution design-based safe harbor for section 401(k) plans by requiring that, in addition to the matching contribution, the employer either (1) make a nonelective contribution for nonhighly compensated employees equal to 1 percent of compensation, or (2) automatically enroll eligible employees in the plan at a 3-percent of compensation contribution rate. In addition, the proposal would permit an employer to reduce the matching contribution, beginning with matching contributions provided at the highest rate of elective contributions, by the amount of safe harbor nonelective contributions under the plan.

Simplify definition of highly compensated employee

The proposal would eliminate the top-paid group election from the definition of highly compensated employee. Thus, an employee would be a highly compensated employee if the employee was a 5-percent owner during the year or the preceding year or had compensation in excess of \$80,000 in the current year.

Tax treatment of the division of section 457 plan benefits upon divorce

The proposal would extend the taxation rules for qualified plan distributions pursuant to a QDRO to distributions from section 457(b) plans made pursuant to a domestic relations order. In addition, a payment from a section 457(b) plan made pursuant to a QDRO would not be treated as violating the restrictions on distributions from such plans.

Require joint and seventy-five percent survivor annuity option for pension plans

Qualified plans that are required to provide a joint and survivor annuity option would be required to offer an option that pays a lifetime benefit to the participant's surviving spouse equal to at least 75 percent of the benefit payable during the participant's lifetime (instead of a 50 percent survivor benefit as under present law).

Encourage pension asset preservation by default rollover to IRAs of involuntary distributions

The proposal would make a direct rollover the default option for involuntary cashouts that exceed \$1,000 and that are eligible rollover distributions from qualified retirement plans, tax-sheltered section 403(b) annuities, or governmental section 457 plans.

Rollovers allowed among various types of plans

Under the proposal, an eligible rollover distribution from a qualified retirement plan could be rolled over to a qualified retirement plan, a section 403(b) tax-sheltered annuity, a governmental section 457 plan, or a traditional IRA. Likewise, an eligible rollover distribution from a section 403(b) tax-sheltered annuity could be rolled over to another section 403(b) tax-sheltered annuity, a qualified retirement plan, a governmental section 457 plan, or a traditional IRA. In addition, an eligible rollover distribution from a governmental section 457 plan could be rolled over to another governmental section 457 plan, a qualified retirement plan, a section 403(b) tax-sheltered annuity, or a traditional IRA.

Rollovers of after-tax contributions

After-tax employee contributions could be rolled over to an IRA or another qualified plan, provided that the plan or IRA provider agrees to keep track of and report the after-tax portion of the rollover.

Rollovers of regular IRAs into workplace retirement plans

Individuals would be able to rollover amounts in a deductible IRA to a qualified plan, section 403(b) annuity, or governmental section 457 plan. Governmental section 457 plans would be required to separately account for such amounts, which would be subject to the additional tax on premature distributions.

Facilitate the purchase of service credits in governmental defined benefit plans

Under the proposal, State and local government employees would be able to use funds from their section 403(b) tax-sheltered annuities or governmental section 457 plans to purchase credits in a defined benefit plan through a direct transfer.

Thrift Savings Plan portability proposals⁸

The proposal would eliminate all waiting periods for employee elective contributions and agency contributions to the TSP for new hires and rehires. In addition, an employee would be allowed to roll over an "eligible rollover distribution" from a qualified trust sponsored by a previous employer to the employee's TSP account.

Permit accelerated funding of defined benefit plans

The proposal would phase up the full funding limitation based on current liability more quickly, so that it would be 170 percent of current liability for years beginning after December 31, 2002. In addition, the 10 percent excise tax on nondeductible contributions would not apply to the extent a contribution is nondeductible solely as a result of the current liability full funding

⁸ The proposal does not involve amendments to the Internal Revenue Code.

limit. Also, the special deduction rule for terminating plans under section 404(g) would be modified so that all contributions needed to satisfy the plan's liabilities upon plan termination would be immediately deductible. In the case of a plan with fewer than 100 participants, liabilities attributable to recent benefit increases for highly compensated employees would be disregarded for this purpose.

Benefit limits for multiemployer plans under section 415

The proposal would eliminate the 100 percent of compensation limitation for multiemployer defined benefit plans. In addition, the rule requiring aggregation of benefits provided from a single employer would be modified to eliminate aggregation between a multiemployer defined benefit plan and a single employer defined benefit plan for purposes of the 100 percent-of-compensation limit. Also, the special early retirement provisions for determining the section 415 limit that currently apply to defined benefit plans sponsored by governmental or tax-exempt employers and qualified merchant marine plans would be expanded to include multiemployer plans.

Full funding limit for multiemployer plans

The proposal would eliminate the current liability full funding limit for multiemployer plans, and require that such plans have an actuarial valuation at least once every 3 years.

Increase disclosure for pension amendments that reduce the future rate of benefit accrual

The proposal would require that the notice of a significant reduction of the rate of future benefit accrual summarize the important terms of the plan amendment. The notice would be required at least 45 days before the effective date of the plan amendment. For a plan with 100 or more active participants, the plan administrator would be required to provide affected participants an enhanced advance notice using specific examples to describe the impact of the amendment, to make available the formulas and factors used in those examples, and to make available a follow-up individualized benefit statement estimating the participant's projected retirement benefits. Failure to comply with the notice requirements would subject the employer to excise taxes and, in some circumstances, would prohibit the amendment from going into effect.

F. Provide AMT Relief for Families and Simplify the Tax Laws⁹

Alternative minimum tax (AMT) relief for individuals

The proposal would allow the deduction for personal exemptions and the standard deduction in computing the alternative minimum tax.

Simplify and increase the standard deduction for dependents

The proposal would modify the standard deduction for an individual who may be claimed as a dependent by another taxpayer to an amount equal to the individual's earned income plus \$700 (indexed for inflation), but not more than the regular standard deduction.

Simplification of the definition of child dependent

The proposal would repeal the present-law support test for a child who meets three requirements: (1) the child is a son, daughter, stepchild, grandchild or foster child of the taxpayer; (2) the child is under the age of 19 (24 in the case of a full-time student); and the child lives with the taxpayer for more than half of the taxable year (the full year in the case of a foster child). Under the proposal, the taxpayer who resides with the child could claim the dependency exemption, if the present-law tests other than the support test are satisfied. The proposal also would provide a tiebreaker rule if more than one taxpayer satisfies the dependency tests with respect to the same child. The proposal would modify the definition of a foster child for these purposes. Finally, the proposal would repeal the gross income test for grandchildren under the age of 19 (24 in the case of a full-time student).

Index maximum exclusion for capital gains on sale of principal residence

The proposal would index the maximum exclusion amounts for gains on the sale of principal residences for inflation.

Tax credit to encourage electronic filing of individual income tax returns

⁹ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for: (1) simplify and increase the standard deduction for dependents; (2) simplification of the definition of child dependent; (3) index maximum exclusion for capital gains on sale of principal residence; (4) tax credit to encourage electronic filing of individual income tax returns; (5) clarification of employment tax treatment of individuals in sheltered workshops; (6) enhance section 179 expensing for small businesses; (7) translation of foreign withholding taxes by accrual basis taxpayers; (8) simplify penalties for failure to file Form 5500; (9) clarify that a domestic corporation is entitled to claim deemed-paid and direct foreign tax credits with respect to certain investments held indirectly by or through passthrough entities; and (10) treat corporations in an affiliated group as a single corporation.

Under the proposal, taxpayers who file their individual income tax returns electronically would be eligible for a temporary (five year), refundable tax credit of \$10. For individuals using a telephone to file their returns via TeleFile, the credit would be \$5. The proposal would also require that, no later than the first year the tax credit would be available, the IRS offer one or more options to the public for preparing and filing individual income tax returns over the Internet at no cost to the taxpayer.

Clarification of employment tax treatment of individuals in sheltered workshops

The proposal would clarify the exclusion from employment taxes for service provided in a sheltered workshop. The exclusion would be limited to service that is both (1) performed for a period of no more than 18 months under a minimum wage exemption certificate issued by the Department of Labor and (2) provided in a sheltered workshop operated by a section 501(c)(3) organization or a State or local government.

Enhance section 179 expensing for small businesses

The proposal would increase the amount of investment that can be expensed to \$25,000, starting in 2001, and would permit the section 179 deduction to be claimed at the entity level for pass-through businesses. The proposal would treat off-the-shelf computer software under section 167(f) as property eligible for section 179 expensing. The proposal would limit eligibility for section 179 expensing to small businesses, defined as those averaging no more than \$10 million in gross receipts over the three preceding taxable years.

Provide optional self-employment contributions act ("SECA") computations

The proposal would combine the two present-law optional methods for computing SECA taxes for farmers and other self-employed individuals. Under the combined method, self-employment income for SECA tax purposes would be two-thirds of the first \$2,400 of gross income. The optional method could be elected an unlimited number of times.

Clarify rules for certain disclaimers

The proposal would treat "transfer-type" disclaimers similarly as "non-transfer-type" disclaimers by allowing partial transfer-type disclaimers. The proposal also would allow a spouse to make a qualified transfer-type disclaimer where the disclaimed property is transferred to a trust in which the spouse has an income interest (e.g., a credit shelter trust). Further, the proposal would provide that a qualified disclaimer for transfer tax purposes also would be effective for Federal income tax purposes (e.g., disclaimers of interests in annuities and income in respect of a decedent ("IRD")).

Simplify the foreign tax credit limitation for dividends from 10/50 companies

The proposal would simplify the application of the foreign tax credit limitation by immediately applying the look-through rule for dividends paid by a 10/50 company, which was enacted with a delayed effective date as part of the Taxpayer Relief Act of 1997.

<u>Interest treatment for dividends paid by certain regulated investment companies to foreign persons</u>

The proposal generally would treat all income received by a U.S. mutual fund that invests substantially all of its assets in U.S. debt securities or cash as interest that is exempt from U.S. withholding tax.

Expand declaratory judgment remedy for noncharitable organizations seeking determinations of tax-exempt status

The proposal would extend declaratory judgment procedures similar to those currently available only to charities under section 7428 to other section 501(c) determinations.

Translation of foreign withholding taxes by accrual basis taxpayers

The proposal generally would require foreign withholding taxes to be translated into U.S. dollars at the spot rate on the date of payment, regardless of the taxpayer's method of accounting.

Simplify penalties for failure to file Form 5500

The proposal would repeal the separate Code and PBGC penalties for failure to file an annual report, Schedule SSA, statement of plan changes and Schedule B for a retirement plan subject to penalties for failure to report under ERISA.

<u>Clarify that a domestic corporation is entitled to claim deemed-paid and direct foreign tax</u> <u>credits with respect to certain investments held indirectly by or through pass-through</u> entities

The proposal would clarify that a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation through a partnership is entitled to claim a deemed-paid credit that is attributable to its proportionate share of dividend income received from such foreign corporation. The proposal also would clarify that a domestic corporation that is a member of a partnership or a beneficiary of an estate or trust may claim a direct foreign tax credit with respect to its proportionate share of foreign taxes paid by the partnership, estate, or trust.

Treat corporations in an affiliated group as a single corporation

The proposal would simplify the active trade or business requirement in tax-free spinoffs by generally allowing an affiliated group to satisfy the requirement as long as the relevant affiliated groups connected with the distributing and the controlled corporations satisfy the requirement.

G. Encourage Philanthropy¹⁰

Charitable contribution deduction for non-itemizers

The proposal would allow taxpayers who do not itemize their deductions to claim a deduction (in addition to the standard deduction) for 50 percent of their charitable contributions in excess of \$1,000 (\$2,000 for taxpayers filing joint returns). For taxable years beginning after December 31, 2005, non-itemizers would be allowed to deduct 50 percent of their charitable contributions in excess of \$500 (\$1,000 for taxpayers filing joint returns).

Simplify and reduce private foundation excise tax

The proposal would replace the two-tier excise tax of up to 2 percent imposed on the net investment income of private foundations with a single excise tax of 1.25 percent.

Increase percentage limits on donations of appreciated property

Under the proposal, the 30-percent limitation for gifts of capital gain property by individuals to public charities would be increased to 50 percent and the 20-percent limitation on gifts of capital gain property to private foundations would be increased to 30 percent.

Clarify public charity status of donor advised funds

Under the proposal, a charitable organization that has as its primary activity the operation of donor-advised funds would qualify as a public charity only if: (1) there is no material restriction that prevents the organization from freely and effectively employing the assets in its donor-advised funds, or the income therefrom, in furtherance of its exempt purposes; (2) distributions are made from its donor-advised funds only to public charities, private operating foundations, or governmental entities; and (3) annual distributions from donor-advised funds equal at least five percent of the net fair market value of the organizations aggregate assets held in donor-advised funds. Failure to comply with any of these requirements would result in the organization's being classified as a private foundation. A similar rule would apply to organizations that maintain donor-advised funds, but not as a primary activity.

¹⁰ No similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal.

H. Promote Energy Efficiency and Improve the Environment¹¹

Provide tax credit for energy-efficient building equipment

A nonrefundable tax credit of 20 percent would be allowed for the purchase of certain energy efficient building equipment, including electric heat pumps, natural gas heat pumps, and fuel cells.

Tax credit for the purchase of energy-efficient new homes

A tax credit of up to \$2,000 would be allowed for the purchase of energy efficient new principal residences that meet certain energy efficiency standards that significantly exceed those set by the International Energy Conservation Code.

Extend tax credit for electric vehicles and provide tax credit for certain fuel-efficient hybrid vehicles

The proposal would extend the present-law 10-percent credit for the purchase of electric vehicles through 2006 and create a new credit of up to \$3,000 for certain hybrid-powered vehicles purchased after 2002 and before 2007.

Extend wind and biomass tax credit and expand eligible biomass sources

The present income tax credit for electricity produced from wind and closed-loop biomass would be extended for an additional 2.5 years, to include facilities placed in service before July 1, 2004. The credit would be expanded to include electricity produced from other biomass and landfill gas (facilities placed in service before January 1, 2006). A reduced credit rate would apply to electricity from certain pre-January 1, 2001 biomass facilities and to electricity from certain facilities that co-fire coal and biomass fuel.

Tax credit for rooftop solar equipment

A nonrefundable tax credit of 15% of qualified investment is allowed for up to a maximum of \$1,000 for solar water heating systems placed in service after December 31, 2000 and before January 1, 2006, and for up to a maximum \$2,000 for rooftop photovoltaic systems placed in service after December 31, 2000 and before January 1, 2008.

¹¹ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposal relating to the 15-year depreciable life for distributed power property.

Provide a 15-year depreciable life for distributed power property

The proposal would assign a shorter, 15-year depreciation recovery period and a 22-year class life to distributed power property placed in service after the date of enactment. For this purpose, distributed power property would include only (1) property used in the generation of electricity for primary use in nonresidential real property or residential rental property used in the taxpayer's trade or business, and (2) property with a rated total capacity in excess of 500 kilowatts that is used in the generation of electricity for primary use in a taxpayer's industrial manufacturing process or plant activity.

I. Electricity Restructuring¹²

Tax-exempt bonds for electric facilities of public power entities

The proposal would enact new rules governing the private business use of electric generation, transmission, and distribution facilities owned by governmental electric service providers ("public power") and financed with proceeds of tax-exempt bonds. In general, the budget proposal would grandfather the tax-exempt status of interest on outstanding public power bonds when the issuers engage in private business use as part of open access electric industry restructuring plans. No future tax-exempt bonds could be issued for generation or transmission facilities.

Modify treatment of contributions to nuclear decommissioning funds

The cost of service requirement for deductible contributions to qualified nuclear decommissioning funds would be repealed. This would allow unregulated utilities to deduct contributions to such funds in the same manner and subject to the same limitations as regulated utilities.

J. Modify International Trade Provisions¹³

Extend and modify Puerto Rico economic-activity tax credit

The proposal would modify the economic-activity-based credit (section 30A) to apply to certain newly established business operations, and would extend the application of the current credit for three years.

¹² Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal.

¹³ This proposal is identical to a proposal contained in the President's Fiscal Year 2000 Budget Proposal.

K. Miscellaneous Provisions¹⁴

Make first \$2,000 of severance pay exempt from income tax

Under the proposal, up to \$2,000 of certain severance payments received in connection with a reduction in the employer's work force would be excludable from gross income. The exclusion would not apply if the total severance payments exceed \$75,000. The exclusion would be temporary.

Exempt Holocaust reparations from Federal income tax

The proposal would exempt from tax any amounts received from the Swiss Humanitarian Fund established by the government of Switzerland or as a result of the settlement of the action entitled In Re Holocaust Victims' Assets, (E.D.N.Y.) C.A. No. 96-4849 (E.D.N.Y., Oct 8, 1998), or from any similar Holocaust-related fund or action, and the value of property recovered as a result of a settlement or legislative resolution of a claim arising out of the confiscation of such property in connection with the Holocaust. Following the recovery, the taxpayer's initial basis in the recovered property would be the fair market value of the property on the date of the recovery.

Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposal to exempt holocaust reparations from Federal income tax.

II. ELIMINATE UNWARRANTED BENEFITS, ADOPT OTHER REVENUE MEASURES

A. Corporate Tax Shelters¹⁵

<u>Increase disclosure with respect to certain reportable transactions</u>

The proposal would create a new disclosure regime for any transaction that has certain characteristics regardless of whether the transaction meets the definition of a corporate tax shelter. Disclosure would be required if a transaction has some combination of the following characteristics: a book/tax difference in excess of a certain amount; certain recission insurance or unwind clauses; involvement with a tax-indifferent party; advisor fees in excess of a certain amount; a confidentiality agreement; the offering of the transaction to multiple corporations; and a difference between the form of the transaction and how it was reported.

Modify the substantial understatement penalty for corporate tax shelters

The proposal would increase the penalty rate applicable to a substantial understatement for items attributable to a corporate tax shelter to 40 percent. The 40-percent rate would be (1) reduced to 20 percent if the corporation fulfilled certain disclosure requirements, and (2) eliminated altogether where the corporation discloses the transaction and satisfies a strengthened reasonable cause standard.

A corporate tax shelter would be defined as any arrangement in which a corporate participant attempts to obtain a tax benefit in a tax avoidance transaction. A "tax avoidance transaction" would be defined as any transaction (1) in which the reasonably expected pre-tax profit is insignificant relative to the reasonably expected net tax benefits; or (2) in the case of financing transactions, any transaction in which the present value of the tax benefits of the taxpayer to whom the financing is provided are significantly in excess of the present value of the pre-tax profit or economic return realized by the person providing the financing.

Codify the economic substance doctrine

The proposal would codify and clarify the economic substance doctrine. The proposal would disallow tax benefits derived in a tax avoidance transaction. The proposal also would apply to all business activities of taxpayers, including those that engage in business in non-corporate forms.

¹⁵ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposals to: (1) increase disclosure with respect to certain reportable transactions; (2) limit the dividend treatment for payments on certain self-amortizing stock; and (3) to increase the depreciation life by service term of tax-exempt use property leases.

Impose a penalty excise tax on certain fees from corporate tax shelters

The proposal would impose a 25-percent excise tax on fees received by promoters and advisors who perform services in furtherance of a corporate tax shelter. Due process procedures would be provided for such parties.

Tax income from corporate tax shelters involving tax-indifferent parties

The proposal would provide that any income allocable to a tax-indifferent party (e.g., a foreign person or tax-exempt organization) with respect to a corporate tax shelter is taxable to the tax-indifferent party if it is trading on its tax exemption. Joint and several liability would exist between the tax-indifferent party and the corporate participants.

Require accrual of the time value element on forward sale of corporate stock

The proposal would require a corporation that enters into a forward contract for the sale of its own stock to treat a portion of the payment received with respect to the forward contract as a payment of interest.

Modify treatment of ESOP as S corporation shareholder

The proposal would require ESOPs that are not broad based to pay unrelated business income tax ("UBIT") on S corporation income (including capital gains on the sale of stock) as the income is earned and allow the ESOP a tax deduction for distributions of amounts previously subject to tax. An ESOP would be considered broad based if the ESOP account balances allocated to highly compensated employees or 2 percent shareholders are less than 10 percent of allocated account balances and the total number of shares of "synthetic equities" do not exceed 10 percent of the S corporation's other outstanding shares.

<u>Limit dividend treatment for payments on certain self-amortizing stock</u>

In the case of a distribution with respect to self-amortizing stock issued by a conduit entity, the amount treated as a dividend would not exceed the amount of the distribution that would have been characterized as a payment of interest if the self-amortizing stock had been a debt instrument.

Prevent serial liquidations of U.S. subsidiaries of foreign corporations

The proposal generally would treat as a dividend any distribution of earnings by a U.S. holding company to a foreign corporation in a complete liquidation, if the U.S. holding company subsidiary of the foreign corporation was in existence for less than five years.

<u>Prevent capital gains avoidance through basis shift transactions involving foreign</u> shareholders

The proposal would limit the ability of taxpayers to receive stock basis from certain stock redemption transactions involving parties that are not subject to Federal income tax.

<u>Prevent mismatching of deductions and income inclusions in transactions with related</u> foreign persons

The proposal would limit the ability of taxpayers to deduct currently amounts accrued but unpaid to certain related foreign corporations.

Prevent duplication or acceleration of loss through assumption of certain liabilities

The proposal would reduce the basis of a contributor's stock in a transfer to a controlled corporation by the amount of certain liabilities assumed by the corporation, unless the trade or business, or substantially all the assets, with which the liabilities are associated are also contributed. The provision would apply only to the extent the basis of the stock would otherwise exceed fair market value.

Amend 80/20 company rules

The proposal would limit the amount of interest and dividend payments from 80/20 companies that are exempt from U.S. withholding tax to the amount of foreign active business income received by the U.S. corporation during a 3-year testing period.

Modify corporate-owned life insurance ("COLI") rules

The proposal would repeal the exception under the COLI proration rules for contracts covering employees, officers or directors, other than 20 percent owners of the business that is the owner or beneficiary of an annuity, endowment or life insurance contract.

Increase depreciation life by service term of tax-exempt use property leases

The proposal would require lessors of tax-exempt use property to include the term of optional service contracts and other similar arrangements in the lease term for purposes of determining the recovery period for such property.

B. Financial Products¹⁶

Require cash-method banks to accrue interest on short-term obligations

The proposal would clarify that a bank must accrue all interest, original issue discount, and acquisition discount on short-term obligations, including loans made in the ordinary course of the bank's business, regardless of the bank's overall method of accounting.

Require current accrual of market discount by accrual method taxpayers

The proposal would require holders of debt instruments that use the accrual method of accounting to include currently in income market discount as it accrues and would provide limits for purposes of determining and accruing market discount.

Modify and clarify rules relating to debt-for-debt exchanges

The proposal would require an accrual-method debt issuer to spread the issuer's net deduction for bond repurchase premium in a debt-for-debt exchange over the term of the new debt instrument using constant yield principles. The proposal also would clarify the measurement of net income or deduction in cases where the new debt instrument is contingent and neither the new debt instrument nor the old debt instrument is publicly traded. The proposal also would modify a holder's tax consequences in a debt-for-debt exchange that is part of a corporate reorganization.

Modify and clarify straddle rules

The proposal would modify and clarify the straddle rules in five respects: (1) the proposal would repeal the stock exception in the straddle rules' definition of personal property; (2) the proposal would clarify that if a taxpayer issues a debt instrument and one or more of the payments on such instrument are linked to the value of personal property, the taxpayer's obligation under the debt instrument is an interest in personal property and may constitute a leg of a straddle; (3) the proposal would provide that loss recognized on one leg of a straddle would be capitalized into a related gain leg of a straddle; (4) the proposal would require that a taxpayer that settles an option or forward contract by delivering property to treat the option or forward contract as if it were terminated for its fair market value immediately before the settlement; and (5) the proposal would clarify that interest is considered properly allocable to a straddle and, therefore, must be capitalized if the interest accrues on a straddle-related debt instrument.

¹⁶ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposals to: (1) modify and clarify the straddle rules; (2) provide generalized rules for all income-stripping transactions; (3) require ordinary treatment for certain dealers of equity options and commodities; and (4) prohibit tax deferral on contributions of appreciated property to swap funds.

Provide generalized rules for all income-stripping transactions

The proposal generally would characterize a separation or "strip" of a right to receive future income from income-producing property as a debt instrument and not as a separate ownership interest in the underlying property. The proposal would limit or prohibit the owner from crediting taxes paid or deemed paid with respect to the property. In certain cases, the proposal would not apply a deemed-financing approach but would characterize a stripping arrangement as an entity and the holders of the income strip and the underlying property as holding interests in the entity. The proposal also would require a taxpayer that enters into a stripping transaction to recognize gain, if any, on the underlying property.

Require ordinary treatment for certain dealers of equity options and commodities

The proposal would require dealers in equity options and commodities to treat the income from their dealer activities as ordinary in character, not capital.

Require recognition of gain on transfers to swap funds

The proposal would require gain to be recognized on the transfer of marketable securities to certain corporations (and partnerships) if the transfer results in diversification of the transferor's interest. The proposal also would broaden the type of assets that are taken into account in determining whether a corporation is an investment company.

C. Corporate¹⁷

Conform control test for tax-free incorporations, distributions, and reorganizations

The present law "control" test would be modified to require at least 80 percent of total voting power and 80 percent of total value of stock, not counting certain nonvoting preferred stock, and would thus conform to the present-law test for affiliation.

Treat receipt of certain tracking stock as property

¹⁷ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposals, except for the proposals to: (1) clarify definition of nonqualified preferred stock; (2) clarify rules for payment of estimated taxes for certain deemed asset sales; (3) modify treatment of transfers to creditors in divisive reorganizations; (4) provide mandatory basis adjustments if partners have significant net built-in loss in partnership property; (5) apply RIC excise tax to undistributed profits of REITs; (6) allow RICs a dividends paid deduction for redemptions only in cases where the redemption represents a contraction in the RIC; (7) require REMICs to be secondarily liable for the tax liability of REMIC residual interest holders; and (8) capitalization of commissions by mutual fund distributors.

The receipt of tracking stock in a distribution made by a corporation with respect to its stock, or in exchange for other stock in the issuing corporation, would be treated as the receipt of property by the shareholders, and thus would not be eligible for tax-free treatment to the shareholders.

Require consistent treatment and provide basis allocation rules for transfers of intangibles in certain nonrecognition transactions

The transfer of an interest in intangible property constituting less than all of the substantial rights of the transferor may be treated as a transfer of property to a controlled corporation or partnership. Basis allocation, and consistent reporting by the transferor and transferee, would be required.

Modify tax treatment of certain reorganizations where portfolio interests in stock disappear

If a corporation owns less than 20 percent of the value of the stock of another corporation (a portfolio interest in the other corporation), and the two corporations combine in certain tax-free reorganization-type transactions, the corporation that owned the portfolio interest would recognize gain (but not loss) as if it had distributed or sold its portfolio interest immediately prior to the reorganization.

Clarify definition of nonqualified preferred stock

Nonqualified preferred stock, which is treated as taxable property under present law, would be defined to clarify that it includes stock for which there is not a real and meaningful likelihood of actual participation in the earnings and growth of the corporation.

Clarify rules for payment of estimated taxes for certain deemed asset sales

In case of a stock sale that is eligible to be treated as an asset sale if the parties agree to make an election under section 338(h)(10), estimated taxes would be required to be paid based upon the deemed asset sale where there is an agreement to make such an election, and based upon the stock sale where there is no such agreement.

Modify treatment of transfers to creditors in divisive reorganizations

If there is a transfer of assets to a controlled corporation that is then distributed, the proposal would limit the amount of property or money that the distributing corporation can distribute to its creditors without the recognition of gain. Also, certain acquisitive reorganizations would no longer be subject to rules requiring gain recognition if liabilities are assumed.

<u>Provide mandatory basis adjustments if partners have significant built-in loss in partnership property</u>

The proposal would make mandatory the present-law elective basis adjustments to partnership property upon certain distributions to partners and certain transfers of partnership interests.

Modify treatment of closely-held REITS

The proposal would impose as an additional requirement for REIT qualification that no person can own stock of a REIT possessing 50 percent or more of the total combined voting power of all classes of stock or 50 percent of the total value of all shares of all classes of stock. A limited look-through rule would be provided for partnerships.

Apply RIC excise tax to undistributed profits of REITS

The proposal would increase the amount of ordinary income and capital gain net income that a real estate investment trust ("REIT") must distribute for a calendar year to avoid the four-percent excise tax imposed under section 4981. The proposed amount (i.e., 98 percent of its ordinary income and capital gain net income) is the same amount that a regulated investment company ("RIC") is required to distribute in order to avoid the imposition of an excise tax.

Allow RICs a dividends paid deduction for redemptions only in cases where the redemption represents a contraction in the RIC

The proposal would limit a RIC's dividends paid deduction with respect to a redemption only if the redemption represents a net contraction of the RIC (as measured by the number of shares outstanding).

Require REMICs to be secondarily liable for the tax liability of REMIC residual interest holders

The proposal would require a real estate mortgage investment conduit ("REMIC") to be secondarily liable for the tax liability of its REMIC residual interest. Thus, if the tax on the residual interest is not paid when due, the REMIC would be liable for the tax.

Deny change in method treatment in tax-free transactions

The proposal would expand the transactions to which the carryover of method of accounting rules in section 381(c)(4) and the inventory method rules in section 381(c)(5) apply to transfers of property to corporations (under section 351) and to partnerships (under section 721). Thus, a new corporation or partnership generally would be required to use the accounting and inventory methods used by the transferring entity.

Deny deduction for punitive damages

Under the proposal, no deduction would be allowed for punitive damages paid or incurred by the taxpayer as a judgment or in settlement of a claim. Where the liability for punitive damages is covered by insurance, any such damages paid by the insurer would be included in the gross income of the insured person and the insurer would be required to report such amounts to both the insured person and the Internal Revenue Service.

Repeal the lower of cost or market inventory accounting method

The proposal would repeal the lower of cost or market and subnormal goods methods. The proposal would not apply to certain small businesses, generally those with average annual gross receipts of \$5 million or less.

Disallow interest on debt allocable to tax-exempt obligations

The proposal would amend the definition of financial institution to which the proportionate disallowance rule applies also to include any person engaged in the active conduct of a banking, financing, or similar business, such as securities dealers and other financial intermediaries.

Capitalization of commissions by mutual fund distributors

Brokerage commissions on sales of mutual fund shares that are paid by the distributor of the mutual fund would be required to be capitalized. The recovery period for these costs would be the same as the period an investor is required to hold the shares to avoid a redemption fee.

D. Cost Recovery¹⁸

Provide consistent amortization periods for intangibles

The proposal would allow an election to deduct up to \$5,000 of start-up expenditures and up to \$5,000 of organizational costs, in the year a trade or business begins. These amounts would be reduced if cumulated start-up and organizational expenses exceed \$50,000. Any costs not deductible under the provision would be amortized over a 15-year period in the same manner as section 197 intangibles.

Clarify class lives for utility grading costs

¹⁸ These proposals are similar or identical to proposals contained in the President's Fiscal Year 2000 Budget Proposal, except for the proposal to extend the current law intangibles amortization provisions to acquisitions of sports franchises.

The proposal would assign a class life to depreciable electric and gas utility clearing and grading costs incurred to locate transmission and distribution lines and pipelines, requiring such costs to be recovered in the same manner as the property to which the clearing and grading costs relate.

Extend the current law intangibles amortization provisions to acquisitions of sports franchises

The special rules for amortization of intangibles in acquisitions of sports franchises would be repealed. Such acquisitions would be treated in the same manner as other acquisitions, so that all acquired intangible assets would be amortized over 15 years.

E. Insurance Provisions¹⁹

Require recapture of policyholder surplus accounts

The proposal would require life insurance companies to include in their gross income over five years their policyholder surplus account balances as of the beginning of the first taxable year starting after the date of enactment.

Modify rules for capitalizing policy acquisition costs of life insurance companies

Under the proposal, the percentages of net premiums required to be capitalized by insurance companies would be modified for five categories of insurance contracts to more closely reflect both the historic ratio of commissions to net premiums from 1994 through 1998 and the typical useful lives for the policies included in each of these categories.

Increase the proration percentage for property and casualty insurance companies

Under the proposal, the reduction in the reserve deductions of a property and casualty company would be increased from 15 percent to 25 percent of the tax-exempt interest or the deductible portion of certain dividends received by the company.

Modify rules that apply to sales of life insurance contracts

The proposal would require information reporting by purchasers of interests in an existing life insurance policy with a death benefit equal to or exceeding \$1,000,000. The information to be reported would be the price, the buyer's and seller's taxpayer identification numbers, and the

¹⁹ These proposals are similar or identical to proposals included in the President's Fiscal Year 2000 Budget Proposal, except for the proposals to modify rules that apply to sales of life insurance contracts and to modify qualification rules for tax-exempt property and casualty insurance casualty companies.

issuer and policy number. Reporting would be made to the Internal Revenue Service, the issuing insurer, and the seller. Exceptions to present-law rules requiring gain recognition with respect to certain purchases of life insurance policies would not apply.

Modify qualification rules for tax-exempt property and casualty insurance casualty companies

The proposal would limit present-law rules permitting tax-exempt status for certain small insurers (with no more than \$350,000 of gross receipts) to apply only to U.S. companies. The proposal would expand the present-law rule permitting property and casualty insurers with gross receipts between \$350,000 and \$1.2 million to elect to be taxed only on investment income, so that the investment income election would apply to property and casualty insurers with gross receipts up to \$350,000 as well. The proposal would prevent a foreign insurance company from electing to be taxed as a domestic insurer if the foreign insurer would be eligible for tax-exempt status.

F. Tax-Exempt Organizations²⁰

Subject investment income of trade associations to tax

Under the proposal, trade associations and other organizations described in section 501(c)(6) would generally be subject to tax (at applicable corporate income tax rates) on their net investment income in excess of \$10,000.

Penalty for failure to file Form 5227

The proposal would impose a penalty for failure to file Form 5227 of \$20 for each day the failure continues, up to a maximum of \$10,000 per return.

Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposal to impose a penalty for failure to file Form 5227.

G. Estate and Gift²¹

Restore phaseout of unified credit for large estates

The proposal would increase the range of the five-percent surtax in order to phase out the benefit of the rising unified credit; the five-percent surtax phases out the benefit of the graduated estate tax rates under present law.

Require consistent valuation for estate and income tax purposes

The proposal would impose a duty of consistency in determining fair market value for estate and income tax purposes. The proposal also would require estates to notify heirs of the fair market value of property as reported on the estate tax return, and it would also require donors of lifetime gifts to notify donees of the donor's basis in property at the time of transfer.

Require basis allocation for part-sale/part-gift transactions

The proposal would require that the basis of property received in a part-gift/part-sale transaction be allocated ratably between the gift portion and the sale portion of the property based on the fair market value on the date of transfer and the consideration paid, similar to treatment for part-sale/part-charitable donations.

Eliminate the stepped-up basis in community property owned by surviving spouse

The proposal would eliminate the stepped-up basis in the part of community property owned by a surviving spouse prior to a deceased spouse's death.

Require that qualified terminable interest property for which a marital deduction is allowed be included in the surviving spouse's estate

The proposal would provide that the value of any qualified terminable interest property ("QTIP") for which the estate tax marital deduction was taken in the estate of the first spouse to die must be (1) included in the surviving spouse's gross estate and (2) subject to gift tax if disposed of during the surviving spouse's life.

Eliminate non-business valuation discounts

The proposal would eliminate valuation discounts, except as they apply to active businesses, to the extent that an entity holds non-business assets (e.g., cash, cash equivalents, foreign currency, publicly traded securities, real property, annuities, royalty-producing assets,

²¹ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposal to modify the requirements for annual exclusion gifts.

non-income producing property such as art or collectibles, commodities, options, and swaps).

Eliminate gift tax exemption for personal residence trusts

The proposal would repeal the personal residence exception to section 2702(a)(3)(A)(ii), and require a trust to pay out the required annuity or unitrust amount when a residence is used to fund a grantor retained annuity trust ("GRAT") or a grantor retained unitrust ("GRUT").

Modify requirements for annual exclusion gifts

The proposal would eliminate the "Crummey" rule and conform the \$10,000 gift tax annual exclusion rule to the generation-skipping transfer ("GST") tax \$10,000 annual exclusion rule by providing that the gift tax annual exclusion would not apply to any transfer to trust for the benefit of an individual unless the transfer met with rules similar to those that apply to generation-skipping transfers to trusts that are direct skips.

H. Pensions²²

<u>Increase elective withholding rate for nonperiodic distributions from deferred compensation plans</u>

The proposal would increase the 10-percent elective withholding rate on nonperiodic distributions (such as lump-sum distributions) from pensions, IRAs and annuities to 15 percent.

Increase section 4973 excise tax for excess IRA contributions

The proposal would increase the section 4973 excise tax for excess contributions to IRAs from six to 10 percent for each taxable year after the taxable year in which an excess contribution is made.

Place limitation on prefunding of certain employee benefits

Under the proposal, the present-law deduction limit for plans maintained by 10-or-more employers would be limited to plans that provide only medical, disability, and group-term life insurance benefits.

Subject signing bonuses to employment taxes

The proposal would impose income tax withholding on signing bonuses and clarify that

²² Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposals to clarify employment tax treatment of choreworkers and to prohibit IRAs from investing in foreign sales corporations.

signing bonuses are subject to other employment taxes, without regard to whether the bonus is conditioned on any additional action by the recipient.

Clarify employment tax treatment of choreworkers employed by State welfare agencies

The proposal would clarify that State agencies, and not the disabled or elderly individual receiving the services, are responsible for withholding and employment taxes for choreworkers paid by State agencies to provide domestic services for disabled and elderly individuals.

Prohibit IRAs from investing in foreign sales corporations

The proposal would prohibit IRAs from investing in foreign sales corporations.

I. Compliance²³

Tighten the substantial understatement penalty for large corporations

The proposal would treat a corporation's deficiency of more than \$10 million as substantial for purposes of the substantial understatement penalty, whether or not the deficiency exceeds 10 percent of the taxpayer's total tax liability.

Require withholding on certain gambling winnings

The proposal would impose withholding on proceeds of bingo or keno in excess of \$5,000 at a rate of 28 percent.

Require information reporting for private separate accounts

The proposal would require life insurance companies to report to the IRS annually the following information with respect to private separate accounts: the taxpayer's TIN, the policy numbers, the total contract account value, the amount of inside buildup for each contract whose cash value was partially or wholly invested in a private separate account for any portion of the year, and the portion of the total contract account value for each such contract that was invested in one or more private separate accounts. For these purposes, a private separate account would be defined as any account with respect to which a related group of persons owned policies whose cash values, in the aggregate, represented at least 10 percent of the value of the separate account.

<u>Increase penalties for failure to file correct information returns</u>

The proposal would increase the general penalty amount for any failure with respect to

²³ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposal requiring information reporting for private separate accounts.

information returns to the greater of \$50 per return or 5 percent of the total amount required to be reported, subject to the present-law overall dollar limitations. The increased penalty would not apply if the aggregate amount actually reported by the taxpayer on all returns filed for that calendar year was at least 97 percent of the amount required to be reported.

J. Miscellaneous²⁴

Modify deposit requirement for Federal Unemployment Tax Act ("FUTA")

The proposal would require an employer with \$1,100 or more in FUTA liability in the prior year to pay Federal and State unemployment taxes on monthly rather than a quarterly basis.

Reinstate Oil Spill Liability Trust Fund tax

The proposal would reinstate the five-cent-per-barrel Oil Spill Liability Trust Fund excise tax for the period beginning after September 30, 2001, through September 30, 2010 and increase the Oil Spill Liability Trust Fund funding limitation to \$5 billion.

Repeal percentage depletion for non-fuel minerals mined on Federal and formerly Federal lands

The proposal would repeal percentage depletion provisions under present law for non-fuel minerals mined on Federal lands where the mining rights were originally acquired under the 1872 law, and on private lands acquired under the 1872 law.

Impose excise tax on purchase of structured settlements

Under the proposal, any person purchasing (or otherwise acquiring for consideration) a structured settlement payment stream would be subject to a 40-percent excise tax on the difference between the amount paid by the purchaser to the injured person and the undiscounted value of the purchased income stream, unless such purchase is pursuant to a court order finding that the extraordinary and unanticipated needs of the original intended recipient render such a transaction desirable.

Require taxpayers to include rental income of residence in income without regard to period of rental

The proposal would repeal the exclusion from income of rent on a dwelling unit, if such dwelling unit is actually rented for less than 15 days during the taxable year.

²⁴ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for the proposals to eliminate installment payment of heavy vehicle use tax and to require recognition of gain from the sale of a principal residence if acquired in a like-kind exchange within 5 years of the sale.

Eliminate installment payments of heavy vehicle use tax

Heavy highway vehicles are subject to an annual highway use tax. The tax rate is graduated up to a maximum of \$550 per year. The tax may be paid annually or in quarterly installments. The proposal would eliminate the installment payment option.

Require recognition of gain from the sale of a principal residence if acquired in a like-kind exchange within five years of the sale

The proposal would require recognition of gain on the sale of a principal residence if the property was acquired in a like-kind exchange within five years of the sale.

K. International²⁵

Require reporting of payments to "identified tax havens"

The proposal generally would impose taxpayer reporting requirements for payments made to entities, accounts or individuals resident or located in certain tax havens that have been identified in a list of jurisdictions to be published by the Treasury Secretary. Failure to report a payment subject to these rules would result in a penalty on the payor equal to 20 percent of the amount of the payment.

Restrict tax benefits for income flowing through "identified tax havens"

The proposal would deny a foreign tax credit for taxes paid to certain tax haven jurisdictions that have been identified in a list of jurisdictions to be published by the Treasury Secretary, and would apply the foreign tax credit limitation rules separately to income earned in or through such a tax haven jurisdiction. The proposal also would restrict foreign tax credits, foreign sales corporation benefits, and deferral benefits for income attributable to a tax haven.

Modify treatment of built-in losses and other attribute trafficking

The proposal would limit the ability of taxpayers to use foreign built-in losses and other tax attributes that accrue outside the U.S. taxing jurisdiction.

Simplify taxation of property that no longer produces income effectively connected with a

²⁵ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal, except for proposals to: (1) require reporting of payments to identified tax havens, (2) restrict tax benefits for income flowing through identified tax havens, (3) simplify taxation of property that no longer produces income effectively connected with a U.S. trade or business, (4) impose a mark-to-market exit tax on individuals who expatriate, and (5) limit basis step-up for imported pensions.

U.S. trade or business

The proposal generally would mark to market property (including rights to deferred income) at the time that the property ceases to be used in or attributable to a U.S. trade or business.

Impose mark-to-market exit tax on individuals who expatriate

The proposal would repeal the current expatriation tax provisions for individuals and in its place impose a mark-to-market exit tax on unrealized gains existing at the time of expatriation, without regard to the expatriate's subjective motivation. The proposal would also treat certain gifts made by an expatriate to U.S. persons as taxable income to the recipient.

Expand effectively connected income rules to include more foreign-source income

The proposal would expand the categories of foreign-source income that could constitute income effectively connected with a U.S. trade or business to include economic equivalents of enumerated categories of income such as interest equivalents and dividend equivalents.

Limit basis step-up for imported pensions

The proposal would provide that an individual would have basis with respect to a distribution from a foreign pension plan only to the extent that the individual previously has been subject to tax (either in the United States or the foreign jurisdiction) on the amounts being distributed.

Replace sales-source rules with activity-based rules

The proposal would replace the current 50/50 source rule for inventory sales with a rule requiring that allocation between production and sales activities be based on actual economic activity.

Modify rules relating to foreign oil and gas extraction income

The proposal would deny the foreign tax credit with respect to all amounts paid or accrued (or deemed paid) to any foreign country by a dual-capacity taxpayer if the country does not impose a generally applicable income tax. The proposal also would replace the special limitation rules applicable to foreign oil and gas extraction income with a separate foreign tax credit limitation under section 904(d) with respect to foreign oil and gas income.

Recapture overall foreign losses when controlled foreign corporation stock is disposed

The proposal would modify the application of the foreign tax credit limitation to apply a

special recapture rule for overall foreign losses, which currently applies to dispositions of foreign trade or business assets, to dispositions of controlled foreign corporation stock.

Modify foreign office material participation exception applicable to inventory sales attributable to nonresident's U.S. office

The proposal would provide that the source rule exception for sales of inventory property for use, disposition, or consumption outside the United States in which the nonresident's foreign office or other fixed place of business materially participates will apply only if a 10-percent or greater income tax from the sale is actually paid to a foreign country with respect to such income.

L. Other Provisions Requiring Amendment of the Internal Revenue Code²⁶

Reinstate superfund excise taxes and corporate environmental income tax

The budget proposal would reinstate the expired excise taxes on oil, petroleum products, certain chemicals, and certain imported substances that were deposited in the Hazardous Substance Superfund. The corporate environmental income tax also would be reinstated.

Impose cost-based user fees to fund a portion of the Airport and Airway Trust Fund program

The proposal would authorize the Federal Aviation Administration to impose cost-based user fees to support a portion of the Airport and Airway Trust Fund program. The current excise taxes that are imposed on commercial passenger and freight transportation and on aviation fuels would be retained at reduced rates.

Increase tobacco excise taxes and impose youth smoking assessment

The cigarette excise tax rate would be increased to 64 cents per pack of 20 cigarettes, effective October 1, 2000. Tax rates in other tobacco products would be increased proportionately. The proposal also would impose assessments on tobacco manufacturers that fail to meet youth smoking reduction targets.

Change harbor maintenance excise tax to a cost-based user fee

The proposal would replace the current *ad valorem* harbor maintenance excise tax with a cost-based user fee, referred to as the "harbor services user fee." The user fee would be available to finance harbor construction, operation, and maintenance activities performed by the Army Corps of Engineers, the costs of operating the Saint Lawrence Seaway, and the costs of

²⁶ Similar or identical proposals were included in the President's Fiscal Year 2000 Budget Proposal.

administering the fee.

Disclosure of tax return information for administration of certain veterans programs

The proposal would permanently extend the income verification provisions²⁷ that authorize the Department of Veterans Affairs to obtain access to self-employment tax information and certain tax information supplied to the IRS and Social Security Administration by third parties. (Access will expire after September 30, 2003 under present law.)

Additional increase in amount of rum excise tax that is covered over to Puerto Rico and the Virgin Islands

An amount equal to \$13.25 per proof gallon of the \$13.50 per proof gallon excise tax imposed on rum that is imported (or brought) into the United States is covered over (paid) to the Governments of Puerto Rico and the United States Virgin Islands. The \$13.25 rate is effective for rum entering the United States before January 1, 2002, after which time the coverover rate will be reduced to its permanent rate of \$10.50 per proof gallon. However, only an amount up to \$20 million attributable to the temporary increase in the coverover rate can be paid to Puerto Rico and the Virgin Islands before October 1, 2000. The proposal would accelerate the payments that are delayed because of this limitation.

Restore premims to UMWA benefit fund

The proposal would provide for a specified annual transfer general Federal funds to the UMWA Combined Benefit Fund and reverse the effects of the court decision in <u>National Coal v.</u> Chater regarding the calculation of the premiums charged coal companies that had contractually agreed to pay for their miner employees' retirement health benefits.

²⁷ See page 872 of the Appendix to the Fiscal Year 2001 Budget.